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MEMORANDUDM FOR: Director of Central Intelligence
Deputy Director of Central Intelligence

VIA : Chairman, National Intelligence Council

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SUBJECT : Soviet Hard Currency Position in 1982: A Change in Mood

1. The serious erosion in the Soviet hard currency position that has been well described in recent intelligence commentary* raises the question of whether the new situation will significantly constrain Soviet policies or actions in the new year.

2. An Earlier Crunch. A hard currency bind is, of course, nothing new in Soviet experience. The last time the USSR found itself in a worrisome current account position -- in the mid-seventies -- it managed to work its way out of it fairly easily. Faced with large trade deficits incurred in 1975-76 and a potential threat to its vaunted creditworthiness rating, the USSR State Bank moved quickly to impose discipline upon its Euroborrowing and slowed down the growth of its imports. By the end of 1978, its current account was back in surplus and the confidence of Western money markets had been reaffirmed. But the problem then was easy:

3. The Lucky Seventies. The broad expansion of Soviet trade during the decade of the Seventies and Moscow's success in 1977-78 in regaining control over its hard currency balance of payments were greatly facilitated by several unique circumstances:

- Large windfall gains derived from a dramatic improvement in the Soviet terms of trade in convertible currencies -- largely oil-price related -- and from a sharp runup of gold prices to dizzying heights in 1979-80.

- A steady redistribution of wealth towards OPEC countries whose appetite for modern weapons opened up a new hard currency market for Soviet arms.

* "USSR in Hard Currency Squeeze" in IEEW 20 November 1981, Page 1; "Soviet Hard Currency Situation", Memo for DCI from NIO for Economics, 18 December 1981.

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- An extraordinarily high level of Eurocurrency liquidity and an eagerness of Western banks to extend, and of governments to subsidize, credits on favorable terms to what was perceived as a politcally stable and economically viable Eastern Bloc.

These factors combined to generate an influx of hard curreny into Soviet coffers sufficient to pay for rising agricultural imports, to reduce outstanding debt and to add to Soviet liquidity. By 1980, the USSR had reached a peak in its comfortable payments position.

4. The Turnaround. The erosion of that position, beginning in 1981, has been striking. In part, it stems from short-run factors -- a Western economic slump, lowering the demand for Soviet exports; and three successive poor Soviet harvests, boosting the requirement for grain and meat imports. But far more important is the change in long-run factors -- an actual or imminent reversal of the three favorable factors cited above -- that now combine to impair the Soviet hard currency position for the foreseeable future:

- The terms of trade have begun to turn against the USSR. World oil market prices have softened, reducing Soviet oil export earnings by about $1 billion in 1981. Gold prices have also plummeted from their 1979 peak. For Moscow, the option of trying to offset these price declines by exporting larger volumes of these commodities has severe limitations -- for oil, because of growing Soviet domestic demand and the increasing difficulties the Soviets face in sustaining present levels of crude output; for gold, because of the risk they would run of spoiling a very thin market.

- The hard currency demand for Soviet arms is no longer expanding and may indeed contract, as petrodollar surpluses diminish.

- The level of Eurocurrency liquidity has declined, and with it the intense lending pressure on the banking system. But most important, events in Poland and the dismal economic prospects throughout Eastern Europe have badly shaken the international financial community's faith in a stable, viable Eastern Bloc. The willingness of European bankers to dispense economic largess to that region is already visibly diminished and the continuing rescheduling agonies are bound to discourage it further. Added to this is the growing recognition that chronic slow growth, balance of payments difficulties and seemingly incurable defects in economic structure have become a Bloc-wide phenomenon. These factors have brought about a fundamental change of mood and perception in the West that must by now be deeply troubling to the Soviet leadership.

5. Structural Problems. The Soviet leaders have already taken the easy measures to bring their current account back into balance -- drawing down their sizeable assets in Western banks, resorting to some short term borrowing and deferring or curtailing their purchases of food products, industrial materials and capital equipment. But these short-term adjustment measures cannot begin to cope with the longer term Soviet structural and political circumstances of the 1980s -- prospects of declining oil exports; a chronic

need for food imports to maintain barely acceptable living standards and for technology imports to bolster lagging productivity; a politically irreducible level of subsidization of client states, particularly of Eastern Europe and Cuba; and the potentially staggering burden of having to sustain even a penurious viability in Poland (Romania? East Germany?) for years to come.

6. Implications. The Soviet leaders are surely aware of these growing financial strictures and their calculations are bound to be influenced by the constraints they impose. While the USSR is not on the brink of a financial disaster, it now faces politically tough choices on a number of key issues:

- How much hard currency earnings to sacrifice on the altar of subsidies to client states (how much low priced oil to Eastern Europe; high-priced sugar from Cuba?)
- Whether to shoulder additional foreign commitments that may impose burdensome financial drains (how many more Afghanistan and Vietnam sink holes?)
- How "concessional" to make arms sales (how many more multi-billion dollar arms "sales" that are virtual grants à la India?)
- How to share out limited foreign exchange resources among competing urgent domestic claimants (how far to improverish the diet in favor of enriching microprocessors?)

7. Western Leverage. In the present situation -- unlikely to change in the foreseeable future -- Western control of credit to the Eastern Bloc does seem to provide a plausible means of subtle leverage vis a vis Moscow. The possibility of achieving a common position among major Western lenders is probably greater on this issue than any other: the banks' faith in the Eastern Bloc's creditworthiness is badly shaken and they find themselves under less compulsion to expand their loan portfolios. Conversely, in the Soviet mind, the future of East-West trade is now, more than ever, dependent on the international financial community's continued support. This realization in itself may work to restrain Soviet actions. A basis for explicit or tacit understandings about some aspects of Soviet behavior, say in Poland, thus now exists.

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